CHAPTER V

TAX ISSUES IN MARRIAGE

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TAX ISSUES IN MARRIAGE

Outline of Instruction

I. REFERENCES.

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E. IRS Publication 504, Divorced or Separated Individuals.

F. IRS Publication 544, Sales and Other Dispositions of Assets.

G. IRS Publication 555, Community Property.

H. IRS Publication 590, Individual Retirement Arrangements (IRAs).

I. IRS Publication 971, Innocent Spouse Relief (And Separation of Liability and Equitable Relief).

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II. INTRODUCTION.

III. FILING STATUS.

A. Single Taxpayers.

1. Defined.

a. Anyone who is not married.

b. Taxpayers are considered unmarried for the whole tax year if either of the following applies: I.R.C. § 7703.

(1) There is a final decree of divorce or separate maintenance by the last day of the tax year. State law will control to determine whether a taxpayer is divorced or legally separated.

(2) There is a decree of annulment, which holds that no valid marriage ever existed.

c. Anyone who is married, but is separated pursuant to a decree of separate maintenance. Taxpayer is considered married for the whole tax year if there is no final decree of divorce or separate maintenance by the last day of the tax year. An interlocutory decree is not a final decree.

(1) According to the Tax Court, an individual is considered legally separated under a decree if the decree "expressly and affirmatively provides that the parties live apart in the future. Capodanno v. Commissioner, 69 T.C. 638 (1978), aff'd, 602 F.2d 64 (3rd Cir. 1978).

(2) A voluntary separation under a voluntary separation agreement does not constitute legal separation for purposes of I.R.C. § 7703(a)(2). See, e.g., Kellner v. Commissioner, 468 F.2d 627 (2d Cir. 1972), aff'g per curiam T.C. Memo 1971-103; Johnson v. Commissioner, T.C. Memo 1980-9.

d. The "Abandoned Spouse Rule." I.R.C. § 7703b. A married but separated spouse who is not "legally separated" within the meaning of I.R.C. § 7703(a)(2) may nevertheless be treated as unmarried under the "abandoned spouse rule." A married individual shall not be treated as married if the taxpayer:

(1) files a separate return from the spouse;

(2) maintains a home that is the principal place of abode of a "qualifying person" (defined later);

(a) A taxpayer maintains a home or household if he or she actually occupies it and it is the principal residence of the "qualifying person" for the period he or she actually lives there. Treas. Reg. § 1.143-1(b)(3); Treas. Reg. § 1.2-2(c)(1).

(b) Temporary absences from the household by the "qualifying person" due to illness, education, business, vacation, military service and visitation with the noncustodial parent will not interrupt the period of occupancy if under circumstances it is reasonable to assume the child will return to the household. Treas. Reg. § 1.2-1(c)(1); Treas. Reg. § 1.143-1(b)(3); Blair v. Commissioner, 63 T.C. 214 (1974).

(3) furnishes over one-half of the cost of maintaining such household during the tax year; **and**

(a) Qualifying "costs of maintaining a household" are expenses incurred for "the mutual benefit of the occupants thereof by reason of its operation as the principal abode of such occupants." Treas. Reg. § 1.2-2(d); Treas. Reg. § 1.143-1(b)(4).

(b) Such expenses include property taxes, mortgage interest, rent, utilities, maintenance and repair expenses, casualty insurance, and food consumed on the premises.

(c) The following expenditures do not constitute the costs of maintaining a household: clothing, education, health, vacations and support costs.

(4) such taxpayer's spouse is not a member of such household during the last six months of the year.

(a) "Not a member of the same household" requires living in separate residences for the last six months of the year of the tax year.

(b) The spouse is considered to live with the taxpayer if he or she was temporarily absent due to special circumstances such as illness, education, business, vacation, and military service.

(c) The Tax Court denied a head of household status to a wife who had moved out of the marital home in August after she was unable to evict her husband. The couple decided to terminate their marriage in June, but because the husband had been unable to find housing, he sometimes slept in her living room. The Tax Court stated that "living apart" requires geographical separation and means living in separate residences. Hopkins v. Commissioner, T.C. Memo 1992-326.

(d) It made no difference where the stay beyond the sixth month period was outside the taxpayer's control. Nemeth v. Commissioner, T.C. Memo. 1982-646.

(e) The taxpayer did not satisfy this requirement where the spouses maintained separate bedrooms and bathrooms. Lyddan v. Commissioner, 721 F.2d 873 (1983).

(f) Taxpayer unsuccessfully argued that he did not live with his wife, even though they resided in the same home, because they were emotionally estranged and did not share the same bedroom. The Tax Court concluded that the notion of "living apart" means "living in separate residences" and requires "geographic separation." Chiosie v. Commissioner, T.C. Memo. 2000-117.

2. Single return (Form 1040, Line 1).

3. Head of Household (Form 1040, Line 4; I.R.C. § 2(b)).

a. Advantages of Head of Household Status:

(1) Tax rates lower for head of household than those filing single.

(2) Standard deduction is higher than is allowed on a single or married filing separate return.

(3) For a married person who lived apart from his or her spouse during the last half of the tax year, qualifying as a head of household allows the use of tax rates that are more favorable than those for married persons filing separately.

(4) May be able to claim credits, such as child care credit (I.R.C. § 21(e)(2))and earned income credit, the taxpayer could not claim on a married filing separate return.

b. To qualify as a head of household, the taxpayer must:

(1) Be a U.S. citizen or resident throughout the year, and

(2) Unmarried or considered unmarried at the close of the year ("Abandoned Spouse Rule"), and

(3) Paid more than half the cost of keeping up (maintaining) a home for the year, and

(4) A qualifying person must have lived with the taxpayer for more than half the year.

(a) The taxpayer must be able to claim an exemption for the qualifying person. However, this test can still be meet if the taxpayer does not claim the exemption only because the noncustodial parent is allowed to claim the exemption for the child (discussed later).

(b) Qualifying person is:

(i) an unmarried child, grandchild, foster child, or adopted child. The child does not have to be the taxpayers dependent.

(ii) any other relative whom the taxpayer can claim as a dependent. A dependent parent does not have to live with the taxpayer.

(c) A parent does not have to have custody of a child to be eligible for head of household filing status. However, the actual time a child spends at a parent's home is used to determine whether the residence constitutes the child's principal residence for over half the tax year.

B. Married Taxpayers.

1. Taxpayer is considered married for tax purposes if married on 31 December. (Unless he qualifies to be treated as "unmarried" –see "Abandoned Spouse" rule).

2. If the taxpayer lives together in a common law marriage that is recognized by the law of the state in which the taxpayer lives, or the state where the marriage began, the taxpayer will be treated as married.

3. If a spouse dies during the tax year, the surviving spouse is treated as married for that entire year and may file a joint return.

4. Filing choices for married taxpayers.

a. Joint return (Form 1040, Line 2; I.R.C. § 6013).

b. Married filing separately (Form 1040, Line 3; I.R.C. § 6012).

5. Nonresident alien spouse election. A taxpayer who is a U.S. resident or citizen may file a joint return with a nonresident alien spouse if both agree to be taxed on their world-wide income (<u>see</u> IRS Pub 519).

6. Joint return (I.R.C. § 6013).

a. The advantage of filing a joint return is that the marginal tax rates applicable are the lowest rates and the standard deduction allowable is the highest.

b. On a married filing jointly return, both spouses include all income, exemptions, and deductions.

c. Disadvantage to a joint return:

(1) Both spouses are responsible, jointly and individually, for tax and any interest or penalty due on a joint return.

(a) The significance of joint and several liability cannot be overstated. The decision by parties contemplating a divorce to file a joint return must be made in recognition of this fact.

(b) If a deficiency of tax is assessed with respect to a joint return and the taxpayers no longer reside in the same household or are no longer married, upon the written request of either taxpayer, the IRS must disclose whether it has attempted to collect the deficiency from the other taxpayer, the general nature of the collection activities, and the amount collected. I.R.C. § 6013(d)(3).

(2) <u>Exceptions</u> for "Innocent Spouses" I.R.C. § 6015; Injured Spouse, IRC § 6402. See Divorce Taxation Outline.

d. Practical Problems: signing returns and refunds.

7. Not filing a joint return may result in higher taxes.

   a. Married taxpayers cannot claim credit for child and dependent care unless a joint return is filed (I.R.C. § 21(e)(2).

   b. Married taxpayers cannot take earned income credit unless a joint return is filed (I.R.C. § 32(d)).

   c. Married taxpayers cannot claim the Hope Scholarship or the Lifetime Learning credits unless a joint return is filed (I.R.C. § 25A(g)(6)).

   d. Married taxpayers cannot deduct student loan interest unless a joint return is filed (I.R.C. § 221(f)(2)).

   e. Married taxpayers cannot rollover a Traditional IRA to a Roth IRA unless a joint return is filed (IRC § 408A(c)(3)(B)(ii).

   f. Married taxpayers cannot take the credit for adoption expenses in most instances if filing a separate return.

   g. Married taxpayers filing separate returns cannot exclude the interest from qualified savings bonds used for higher education expenses.

   h. Married filing separately will result in the taxpayer being subject to the limit on the child tax credit, itemized deductions, and the phaseout of the deduction for personal exemptions at income levels that are half of those for a joint return.

8. Married filing separately (I.R.C. § 6012).

   a. If married individuals do not file a joint return and neither of them qualifies as unmarried under I.R.C. § 7703(b), they must each file a separate return using the married filing separately rates.

   b. Each spouse reports own income, exemptions, and credits. Each spouse is responsible only for the tax due on his or her own return.

   c. In most instances, filing of separate returns will result in the payment of more combined federal taxes than a joint return because the tax rate is higher for married filing separately.

   d. Separate returns may save taxes where filing separately allows the taxpayer to claim more deductions. On separate returns, larger amounts of medical expenses, casualty losses, or miscellaneous deductions may be deductible because lower adjusted gross income floors apply.

   e. If one spouse itemizes, both must itemize (not allowed to take the standard deduction if the other spouse itemizes).

      (1) A married person filing a separate return cannot claim the standard deduction if their spouse files as head of household and elects to itemize deductions.

      (2) However, if a married person filing a separate return itemizes, the other spouse can claim the standard deduction if filing as head of household.

      (3) *See*, Significant Service Center Advice, ILM 200030023, Memorandum for Kenneth J. Rubin, Assistant District Counsel Pennsylvania District Counsel, from Lewis J. Fernandez by George Baker, Deputy Assistant Chief Counsel (27 Jun 00). A copy of the memorandum can be found at Tax Notes Today, 2000 TNT 147-42, July 31, 2000.

f. Taxpayers in community property states (i.e., Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, & Wisconsin):

(1) may report one-half of community income on separate returns.

(2) generally report their own income if living apart and file separate returns (I.R.C. § 66a; IRS Pub. 555, Community Property and the Federal Income Tax).

(3) Cannot electronically file a MFS tax return.

C. IRS Individual Income Tax Return Filing Status.

1. Check the appropriate block on Form 1040, Lines 1-5.

2. Married filing separately must specifically list the spouse's name and social security number of the spouse on line 3.

IV. INNOCENT SPOUSE RELIEF (I.R.C. § 6015)

A. In 1998, new provisions of the Internal Revenue Code were enacted in response to concerns that the former law was not providing proper relief to innocent spouses. Unknowing spouses, often divorced or deserted, found themselves responsible for huge tax deficiencies because of joint and several liability.

B. Expanded innocent spouse relief applies to liabilities for tax arising after 22 July 1998 or before that remains unpaid.

C. In the wake of the 1998 change making it easier to claim innocent spouse relief, the IRS expected 3,000 claims for such status but has actually received more than 79,000 claims (more than 90% from women since the summer of 1998). See *Tax Notes Today*, 2000 TNT 115-4 (Jun. 14, 2000).

1. The majority of innocent spouse claims are filed by unrepresented taxpayers.

2. Currently processing time for the claim is in excess of 300 days.

D. In general, innocent spouse relief is easier to obtain. New provision eliminates all understatement thresholds and requires only that the understatement of tax be attributable to an erroneous item of the other spouse. Previously the understatement of tax had to be more than $500.

E. If innocent spouse relief is granted, the taxpayer can be relieved of responsibility for paying tax, interest, and penalties if the other spouse did something wrong on the tax return. If relieve is granted, the IRS can only collect for those items from the spouse.

F. Three types of relief:

1. Innocent Spouse Relief. I.R.C. § 6015(b).

2. Separation of Liability. I.R.C. § 6015(c).

3. Equitable Relief. I.R.C. § 6015(f).

G. Innocent Spouse Relief (I.R.C. § 6015(b)): In order to qualify for innocent spouse relief, the taxpayer must meet all of the following conditions:

1. The taxpayer filed a joint return which has an understatement of tax due to erroneous items of the spouse.

   a. Erroneous items are either unreported income or incorrect deductions, credits, or property basis.

   b. An understatement of tax is generally the difference between the total amount of tax that should have been shown on your return and the amount of tax that was actually shown on your return.

2. The taxpayer must establish that at the time he/she signed the joint return they did not know, and had no reason to know, that there was an understatement of tax. See, <u>Butler v. Commissioner</u>, 114 T.C. No. 19 (2000).

3. Taking into account all the facts and circumstances, it would be unfair to hold the taxpayer liable for the understatement of tax. A spouse seeking relief is not permitted to "turn a blind eye" to facts that are available to him/her. <u>Charlton v. Commissioner</u>, 114 T.C. 22 (2000). Two indicators the IRS may use to decide that it is unfair to hold a taxpayer responsible for the tax are whether the taxpayer:

   a. Received any significant benefit (directly or indirectly) from the understatement of tax, or

b. Were later divorced from or deserted by the spouse.

H. Relief by Separation of Liability.

1. Provides for a separate liability election for a taxpayer who, at the time of election, is no longer married to, is legally separated from, or has been living apart for at least 12 months from the person with whom the taxpayer filed a joint return. The election limits any deficiency to items allocable to that taxpayer.

2. The taxpayer making the request has the burden of proof in establishing the basis for separating liabilities.

3. Even if the taxpayer meets the requirement for separate liability relief, the request will be considered invalid if:

   a. The IRS proves the taxpayer and spouse transferred assets as part of a fraudulent scheme.

   b. The IRS proves that at the time the taxpayer signed the joint return they had actual knowledge that any items giving rise to the deficiency and allocable to the spouse were incorrect.

   c. There was a transfer of property to the spouse (or former spouse) joint to avoid tax or the payment of tax.

4. Under the relief by separation of liability, the taxpayer allocates (divide) the understatement of tax (plus interest and penalties) on the joint return between the taxpayer and spouse (or former spouse). The understatement of tax allocated to the taxpayer is generally the amount the taxpayer is responsible for.

5. This relief by separation of liability can be requested whether or not the taxpayer requests innocent spouse relief.

I. Equitable Relief: IRS has authority to relieve an individual of liability if relief is not available under the innocent spouse rule or separate liability election, but it would be inequitable to hold the individual liable for any unpaid tax or any deficiency. The IRS can grant equitable relief for responsibility for tax, interest, and penalties. In order to qualify for equitable relief the taxpayer must meet all of the following conditions:

1. Taking into account all the facts and circumstances, it would be unfair to hold the taxpayer liable for the understatement or underpayment of tax.

2. The taxpayer is not eligible for innocent spouse relief.

3. The taxpayer is not eligible for separation of liability.

4. The IRS has issued permanent guidance for individuals seeking equitable innocent spouse relief. Rev. Proc. 2000-15.

5. Tax Court can review the denial of equitable relief. Fernandez v. Commissioner, 114 T.C. 21 (2000); I.R.S. Action on Decision, 2000-06.

J. The IRS is required to inform the other spouse (or former spouse) if a taxpayer request innocent spouse relief or separation of liability, and will allow the spouse (or former spouse) to participate in the determination of the amount of the relief from liability. The "nonelecting spouse" has the right to participate in the administrative and judicial review of a claim for innocent spouse relief. Corson v. Commissioner, 114 T.C. No. 24 (2000).

K. Expanded innocent spouse relief and separate liability election must be elected no later than two years after the date on which the IRS has begun collection activities.

L. Tax Court has jurisdiction with respect to disputes about innocent spouse relief in two situations:

1. If the taxpayer disagrees with the IRS' determination notice telling the taxpayer the extent to which the request for relief has been denied.

2. If the taxpayer does not receive a determination notice from the IRS within six months from the date the Form 8857 was filed.

3. A petition with the U.S. Tax Court in order for it review a request for innocent spouse relief. The petition must be filed no later than 90 days from the date the IRS mails its determination notice to the taxpayer.

M. Innocent spouse relief is requested by filing Form 8857. The IRS will review Form 8857, figure the understatement or underpayment of tax and related interest and penalties, and notify the taxpayer if they qualify for innocent spouse relief.

N. IRS advises taxpayers in abusive situations to note the issue on the top of the Form 8857 by writing "Abused Innocent Spouse" and highlighting it. That will alert the IRS to treat the information on the request for relief as very sensitive. See *Tax Notes Today*, 2000 TNT 115-4 (Jun. 14, 2000).

V. INJURED SPOUSE CLAIM & ALLOCATION

A. In some cases a joint overpayment (refund) is applied to a past-due obligation for child support, spousal support, or a debt owed the federal government (such as student loans). I.R.C. § 6402(c). Also, past due state income tax. I.R.C. § 6402(e)(1).

B. The spouse not liable for the past-due support or nontax debt (the "injured spouse"), can file Form 8379 and the IRS can allocate the refund properly. Treas. Reg. § 301.6402-6(i)(2).

C. A taxpayer can qualify as an "injured spouse" if the following conditions are met:

1. The taxpayer is not required to pay the past-due amount.

2. The taxpayer received and reported income on the joint return (this condition does not apply if main home was in a community property state other than Arizona).

3. The taxpayer made and reported tax payments (such as tax withholding from wages), or claimed the earned income credit or other refundable credit on the joint return.

D. Refunds that involve community property states must be divided according to local law. In community property states in which all community property is subject to the debts of either spouse, the entire refund can be used to pay those debts.

E. The Injured Spouse Claim and Allocation is made on IRS Form 8379.

F. Taxpayers that have not filed a current tax return should attach Form 8379 behind the regular tax return in the order of the attachment sequence and enter "Injured Spouse" in the upper left corner of the return.

G. Taxpayers that have already filed a current year tax return and now wish to file a Form 8379 should mail the Form 8379 by itself to the IRS Center for the place the taxpayer lived when they filed their tax return. The taxpayer needs to include copies of their W-2 forms of both spouses, and any Form 1099-R showing income tax withheld.

H. Part II of the 8379 allows the "injured spouse" to allocate between spouses of items on the joint return. The IRS will compute the amount of any refund due the injured spouse.

I. The IRS has made available *Significant Service Center Advice* on how to apply a joint overpayment to separate liabilities. Memorandum, Assistant Chief Counsel (Income Tax and Accounting), Internal Revenue Service, to District Counsel, South Texas District, Austin, subject: Significant Service Center Advice (11 Feb 1998). A copy of the memorandum can be found in WESTLAW, Tax Notes Today, TNT Database, 98 TNT 124-70, June 29, 1998.

VI. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

A. General Rule (I.R.C. § 71; Treas. Temp. Reg. § 1.71-1T).

1. Alimony payments are considered gross income to payee.

2. Deductible by the payor as a deduction/adjustment from gross income (I.R.C. § 62(a)(10) and 215(a)). The payor does not have to itemize to be allowed the deduction.

3. Alimony is treated as earned income so the divorced spouse may separately establish an IRA and contribute up to $2,000 per year or amount of alimony if less than $2,000 per year. I.R.C. § 219(b)(4).

B. Requirements for Alimony Tax Treatment (I.R.C. § 71).

1. Payments must be made in cash (I.R.C. §§ 71(b)(1), 215(b)). Debt instruments of the payor or a third party issued to or transferred to the payee are not considered cash payments. Treas. Reg. § 1.71-1T(b), Q&A-5.

2. Payments must be made and received under a qualifying instrument.

a. Includes a decree of divorce or separate maintenance, written separation agreement, or a decree requiring support or maintenance payments to a spouse.

b. The "instrument incident to a decree of divorce" generally describes writings containing marital settlement terms which are referred to but not merged in the divorce decree, including both formal separation agreements and writings which lack characteristics of a contract, such as a letter. In order for an instrument to be considered "incident to divorce," the writing must provide adequate proof of the existence of a contract between the parties and it must memorialize the parties' understanding regarding the payment terms. I.R.C. § 71(b)(2)(A), Brooks v. Commissioner, T.C. Memo. 1983-304.

c. A written separation agreement in divorce practice ordinarily embodies a declaration of separation, the terms of the marital separation, and payment of support and division of marital property.

(1) Neither the Tax Code, nor the Treasury Regulations define “written separation agreement” for alimony purposes. Jacklin v. Commissioner, 79 T.C. 340, 346 (1982); Leventhal v. Commissioner, T.C. Memo. 2000-92; Keegan v. Commissioner, T.C. Memo. 1997-359.

(2) As construed by the IRS and the Tax Court, a separation agreement under I.R.C. § 71(b)(2)(B) need not be legally enforceable so long as it entered “in contemplation of separation status” and entails a meeting of the minds on the payment terms. Bogard v. Commissioner, 59 T.C. 97 (1972); Treas. Reg. § 1.71-1(b)(2)(I); Richardson v. Commissioner, 97-2 U.S.T.C. Para. 50,653 (7^{th} Cir. 1997), (cash payments made pursuant to separation agreement later determined to be unconscionable and therefore unenforceable are taxable alimony to payee spouse regardless of the state court’s reason for invalidating the agreement).

d. Payments made merely to comply with a service regulation (e.g., AR 608-99) are not pursuant to a qualifying instrument and are not alimony.

e. If made under a decree of divorce or separate maintenance, the payment must be made after the decree (Treas. Reg. § 1.71-1(b)(1)). If made under a separation agreement, the payment must be made after the execution of that agreement (Treas. Reg. § 1.71-1(b)(2)).

3. The divorce or separation instrument must not designate that the payments will not be includable in the gross income of the recipient (see example provision, Appendix C, clause 2).

a. A taxpayer and spouse may designate that otherwise qualifying payments are not alimony. This is done by including a provision in the divorce or separation instrument that states the payments are not deductible by the taxpayer and are excludable from the spouse's income.

b. However, if a divorce or separation instrument designates a payment that would otherwise qualify as alimony as not to be treated as alimony (e.g., as a property settlement), the payment will not qualify as alimony. I.R.C. § 71(b)(1)(B).

c. A taxpayer was divorced in Virginia and part of the settlement required him to provide his ex-spouse with 37.5% of his military retirement. Both parties were denied spousal support. Husband separated from the U.S. Navy and received a lump sum separation payment in lieu of retirement benefits. The ex-spouse petitioned a court in Illinois, where the husband resided to enforce the Virginia order. The IRS determined the payment was not an alimony payment and the husband could not deduct the payment. Generally, alimony is deductible to the extent the alimony is includable in the former spouse's gross income. However, both the Virginia decree and the Illinois order clearly contemplated that this payment was not to be alimony since neither party was to receive spousal support and the payment was to be a non-taxable event. Maloney v. Commissioner, T.C. Memo 2000-214, 2000 Tax Ct. Memo LEXIS 255.

4. There must be no requirement that payments continue beyond the death of the payee spouse (e.g., to the estate) or that any substitute payment is made after the death of the payee spouse (I.R.C. § 71(b)(1)(D)).

a. Payments must end at death of the payee spouse. This requirement is to discourage classification of large cash settlements in payment for marital property as deductible alimony.

(1) Settlement agreement provided that taxpayer would pay certain sum for 142 payments without regard to death of payee spouse. Court looked to state law which did not help. Liability to make payments must terminate at the death of the payee spouse in order for such payments to be alimony. If a payor spouse continues to be liable to make even one otherwise qualifying payment after the death of the payee spouse, none of the related payments required before the payee spouse's death will be alimony. Cunningham v. Commissioner, T.C. Memo. 1994-474, 68 T.C.M. (CCH) 801 (1994) (Treas. Reg. § 1.71-1T(b), Q & A-13.

(2) Will not be considered alimony if the payments do not meet the requirement of I.R.C. § 71(b)(1)(D), that the payments not extend beyond the death of the payee spouse. Stokes v. Commissioner, T.C. Memo. 1994-456, 68 T.C.M. (CCH) 705 (1994).

b. To make sure of alimony treatment, the divorce or separation instrument should specify that otherwise qualifying payments will cease at the death of the recipient.

c. While alimony payments must terminate at the death of the payee, I.R.C. § 71(b) does not require that payments terminate at the death of the payor. If the payor's estate is required to continue alimony payments after the payor's death, the estate is not entitled to an alimony deduction for the payment. However, under I.R.C. § 682(b), such payments are treated as distributions to an estate beneficiary subject to the normal estate distribution rules. If the estate has distributable net income, the estate can take a deduction for the distribution and the payment is included in the payee's income as a distribution from the estate.

5. Payments must not be made during a tax year for which the payor and payee file a joint return. I.R.C. § 71(e).

6. Payments must not be to a member of the same household after a decree of divorce or separate maintenance has been issued or it will not be treated as alimony (I.R.C. § 71(b)(1)(C)). However, if spouses are not legally separated, a payment under a written separation agreement or temporary support order may be alimony even if they are members of the same household (Treas. Reg. § 1.71-1T(b), Q&A-9); Benham v. Commissioner, T.C. Memo. 2000-165 (May 22, 2000).

   a. Spouses will not be treated as members of the same household if one spouse is preparing to leave it, and does leave within one month after the payment.

   b. Coltman v. Commissioner, 980 F.2d 1134 (7th Cir. 1992), aff'd 61 T.C.M. 2207 (CCH) (1991), court applied Treas. Reg. § 1.71-1(b)(3)(i) and held that husband who used suburban marital home as part-time way station between his business and his real residence in another city, where he lived with "significant other" for most of the week, was not entitled to "alimony" deduction for payments to the former wife.

C. Payments may be made to a third party if spouse consents or instrument specifically calls for the third-party payment. I.R.C. 71(b)(1)(A). These can include payments for spouse's living expenses, food, clothing, insurance, medical expenses, housing costs, taxes, tuition, vacations, etc. The payments are treated as received by the spouse and then paid to the third party. Temp. Treas. Reg. § 1.71-1T(b); Priv. Ltr. Rul. 87-10-089.

1. Payments to third parties encompass payments to third parties made pursuant to a written request, consent or ratification of the payee. The qualifying instrument or writing must declare the parties' intent that the payment be treated as alimony subject to the rules of I.R.C. § 71 and must be received by the payor spouse prior to the date of filing his or her income tax return for the taxable year in which the payment is made. Treas. Reg. § 1.71-1T(b), Q&A-7.

2. However, payments made to maintain property owned by the payor spouse but used by the payee spouse (including mortgage payments, realty taxes, and insurance premiums) are not payments on behalf of the payee spouse (i.e., not alimony) even if made under the terms of the divorce or separation instrument. Treas. Reg. § 1.71-1T(b).

3. A payor spouse who is required by the divorce or separation instrument to pay the mortgage on a home he owns jointly with the payee spouse may deduct one-half of those payments as alimony, if they otherwise qualify (the rest may be deductible as qualified residence interest if paid on a qualified home).

4. The Tax Court has held that a man may deduct as alimony one-half of the housing payments he made "on behalf of" his wife, finding that letters qualified as a written separation agreement. Leventhal v. Commissioner, T.C. Memo. 2000-92 (2000).

5. Be careful of disguising child support as alimony. Payments which are for specific expenses of children as they arise may be considered child support and not alimony. Preston v. Commissioner, 2000 U.S. App. LEXIS 7190 (April 20, 2000).

D. Premiums a taxpayer must pay under a divorce or separation instrument for life insurance on their life qualify as alimony to the extent the spouse owns the policy. Temp. Treas. Reg. § 1.71-1T(b).

E. Compliance Provisions.

1. Recipient must furnish taxpayer ID number to payor. I.R.C. § 215(c).

2. Payor must include recipient's number on return. I.R.C. § 215(c).

3. Separation agreements should include parties' social security numbers (see sample provision, Appendix C, clause 3).

F. Making Property Settlement Transfers as Alimony.

1. Alimony payments no longer need to be made in satisfaction of an obligation to support. The payments do not have to be periodic, or in discharge of a legal support obligation arising out of the marital or family relationship (Treas. Reg. § 1.71-1T(a)).

2. Rules limiting treatment of property transfers as alimony.

   a. Alimony payments must be made in cash.

   b. Recapture rules (effective for decrees after 1986) (I.R.C. § 71(f)(2)).

      (1) If total alimony payments in year one exceed the average annual payments made in years two and three by more than $15,000, the excess is recaptured in the payor's gross income in the third year.

      (2) If payments in the second year exceed payments in the third year by more than $15,000, the excess is recaptured in the payor's gross income in the third year.

      (3) The recapture rules do not apply:

         (a) if payments in three post-separation years are under $15,000 per year,

         (b) if the reason for the reduction is the death or remarriage of the payee spouse, or

         (c) if payments change because they are based on a fixed portion of the income from a business or property or from compensation from self-employment (I.R.C. § 71(f)(2)).

      (4) Example - <u>see</u> Appendix D.

VII. CHILD SUPPORT PAYMENTS (I.R.C. § 71(C); TEMP. TREAS. REG. § 1.71-1T).

A. General Rule.

1. Payments specified in a divorce decree or separation agreement as child support are **not** includable in gross income.

2. Child support payments are **not** deductible by payor.

B. Unallocated Family Support.

1. If the amount of child support is not specified in the instrument, the amount to be decreased upon a contingency relating to a child will be treated as child support. Reverses rule of Commissioner v. Lester, 366 U.S. 299 (1961). Contingencies relating to a child include reaching the age of majority, marriage, death, earning specified income level, gaining employment, and leaving the home of custodial parent.

Example: Separation agreement provides that H shall pay $500 per month for family support (unallocated). This amount shall be reduced by $50 per week per year when H has uninterrupted visitation with the child. Amount of the reduction ($50 is treated as fixed for child support. Total of $2,600 ($50 X 52 weeks) does not qualify as alimony (Priv. Ltr. Rul. 8746085).

2. Payments to be reduced at a time that can be "closely associated" with such a contingency will also be treated as child support.

   a. Where payments are reduced not more than six months before or after the child is to attain the age of 18, or 21, or the local age of majority.

   b. Where the payments are reduced on two or more occasions before or after a different child attains a certain age between the ages of 18 and 24, inclusive.

Example: Divorce decree grants a 30-year-old ex-wife custody of her 10-year-old son. Decree provides for unallocated support in amount of $500 per month to be reduced to $200.00 when ex-wife attains age of 38. A total of $300.00 will be treated as "fixed" child support.

3. Effective for decrees executed after 31 December 1984.

4. Cases.

   a. Preston v. Commissioner, 2000 U.S. App. LEXIS 7190; 13 Fla. Law W. Fed. C 603 (2000)(payments made by taxpayer to his former spouse and others for his children's expenses were not deductible as alimony and these payments were child support and nondeductible).

   b. Bay v. Commissioner, T.C. Memo. 1994-389, 68 T.C.M. (CCH) 396 (1994) (unallocated family support and spousal maintenance payments originally structured (and treated as alimony) were transformed on ex-wife's remarriage into child support payments and were no longer deductible as alimony).

   c. Fosberg v. Commissioner, T.C. Memo. 1992-713, 64 T.C.M. (CCH) 1527 (1992) (payments to a former spouse that were to be discontinued upon the earliest of the taxpayer's death, the taxpayer's remarriage, or the youngest child reaching age 18 were not alimony).

C. Priority Rule (§ 71(c)). If all support payments (alimony and child support) are not made, the payments that were made will be treated as child support first.

VIII. EXEMPTIONS (FORM 1040, LINES 6a-d; 38).

A. Each personal exemption claimed on the 2001 tax return is the equivalent of a $2,900 deduction.

B. Personal Exemption (See generally IRS Pub. 501, Exemptions, Standard Deduction, and Filing Information).

1. A personal exemption may be claimed only if another taxpayer is not entitled to claim the person (I.R.C. §151(c)(2)).

2. Benefit of personal exemption is phased out for taxpayers with high incomes.

C. Exemption for Spouse (I.R.C. § 151(b)).

1. Automatic on a joint return. These exemptions are allowed whether or not a spouse has gross income or is a dependent of another taxpayer (though the other taxpayer will be denied an exemption) (Treas. Reg. § 1.151-1(b)).

2. On a separate return, the taxpayer may claim an exemption for a spouse only if the spouse has no gross income, and is not the dependent of another (I.R.C. § 151(b)).

3. If the spouse is a nonresident alien, has no income from U.S. sources, and is not a dependent of another person, the taxpayer may claim an exemption for the spouse on a separate return.

D. Exemption(s) for Dependents (I.R.C. § 151(e)).

1. An exemption is allowed for each person who qualifies as a dependent.

2. Children must have social security numbers.

3. Test for determining who is a dependent.

a. Member of household or relationship test (I.R.C. § 152(a)).

(1) Must be a child, stepchild, adopted child, foster child, brother, sister, parent, grandparent, or other qualified relative, or

(2) Must have lived with the taxpayer for entire year (Treas. Reg. § 1.152-1(b)).

b. Citizenship test (I.R.C. § 152(b)(3); Treas. Reg. 1.152-2(a)).

(1) Must be citizen or national of U.S. or

(2) Resident or national of U.S., Canada or Mexico.

(3) A resident alien can claim personal exemptions and dependency exemptions under the same rules as U.S. citizens. But no joint return can be made if either the husband or wife is a nonresident at any time during the tax year, unless the nonresident alien spouse elects to file a joint return and be treated as a resident for tax purposes. (I.R.C. § 6013(g); Treas. Reg. § 1.6013-1(b)).

c. Joint Return Test. Taxpayer may not claim exemption for a dependent who files joint return with another (I.R.C. § 151(e)(2)).

d. Gross income test (I.R.C. § 151(e)(1)).

(1) Dependent must have earned less than personal exemption amount ($2,900 for 2001).

(2) Gross income test **does not apply** to a child of a taxpayer who is either under age 19 or a full-time student and under age 24 (I.R.C. § 151(c)(1)(B)).

(a) To qualify as a student, the child must, during some part of each of at least five calendar months, whether or not consecutive, during the calendar year in which the taxpayer's year begins, be a full-time student enrolled at an educational institution, or must pursue a full-time course of institutional on-farm training (I.R.C. § 151(c)(4); Treas. Reg. § 1.151-3(b)).

(b) An individual was entitled to claim a dependency exemption for his daughter who was a full-time university student. Although the daughter attended classes for only four months of the calendar year at issue, she was registered with the university for five months. The ordinary meaning of enrollment is registered and is not dependent on attendance. The intent of the regulation is that a student will qualify as full-time if registered for a semester in full-time course of study. Priv. Ltr. Rul. 98-38-027 (Sept. 21, 1998).

(c) A child who attends school exclusively at night is not a full-time student (Treas. Reg. § 1.151-3(b)).

e. Support test (I.R.C. § 152(a)).

(1) Taxpayer must have provided over one-half person's support.

(2) Requires taxpayer to determine total amount of support furnished from all sources and the support furnished by the taxpayer.

(3) In order to be entitled to the dependency exemption, the taxpayer must prove he provided over one-half of the child's support. Batson v. Commissioner, T.C. Memo. 2000-172 (2000).

E. Exemptions for Children of Divorced or Separated Taxpayers (IRC § 152(E)).

1. General Rule.

a. The custodial parent is generally entitled to the exemption.

b. Custody is usually determined by the most recent decree of divorce or separate maintenance. If there is no decree, then pursuant to a separation agreement.

c. If neither a decree nor an agreement establishes custody, then the parent who had physical custody of the child for the greater part of the year is considered the custodial parent.

(1) Under this special rule the parent who had custody of the child for the greater part of the year, the "custodial parent," is generally treated as the parent who provided more than half the child's support.

(2) Focus on counting number of days of custody and not on amount of support provided.

d. The identity of the custodial parent is not always clear, particularly where the divorce instrument provides that the divorced parents have shared 50-50 physical custody of the child.

e. Practice Note: If a settlement agreement will provide for 50-50 shared custody and for alternating dependency exemption and dependent care credit between the parents from year to year, the agreement should identify which parent is the custodial parent for tax purposes.

2. Basic Requirements. I.R.C. § 152(e).

a. Child must receive over half total support from <u>both</u> parents.

b. Parents must be divorced or separated pursuant to written agreement or decree or have lived apart for last 6 months of calendar year.

c. Child must be in custody of one of the parents for more than one-half of the year (<u>see</u> <u>Rownd v. Commissioner</u>, T.C.Memo. 1994-465, 68 T.C.M. (CCH) 738 (1994) (After child reaches majority, regular 5-part dependency test "reapplies"--especially where one parent provides college financial support; dependency exemption then goes according to normal rules)).

3. Exceptions to General Rule (IRC § 152(e)(2)).

a. Custodial parent waives right to claim the exemption.

(1) Waiver can be permanent or annual.

(2) <u>Non</u>custodial parent must attach the waiver to his tax return when claiming the exemption (each year) (IRS Form 8332).

(3) Can an IRS Form 8332 be nullified?

(a) This question is not answered on the form itself, any IRS publications, and the IRS has not published procedures for revoking the release.

(b) The only way a custodial parent can void a Form 8332 and claim the child on his or her return, is to get the noncustodial parent to forego claiming that child as a dependent. If the two former spouses cannot agree and both claim the same child, then the IRS will step in and audit the returns. I.R.S. Legal Memo. 2000-07-031.

(4) The Tax Court upheld the IRS in disallowing a noncustodial parent's claimed dependency exemption where he merely attached to his return a letter signed by his former wife which tracked the language of the divorce decree providing that the husband would be entitled to claim the children as dependents and that the wife would be required to sign any documents necessary to enable the husband to do so. The letter failed to state that the wife would not claim the children as dependents and lacked the other specific items of information required by the Code, Regulations, and Form 8332. White v. Commissioner, T.C. Memo 1996-438.

(5) Under a divorce decree, the wife had sole custody of children, but the husband was provided the children on his tax return as exemptions. The husband claimed the children on his tax return, but did not attach a copy of Form 8332. Instead the husband attached a copy of a portion of the divorce decree to the return. The IRS disallowed the claimed dependency exemption by the husband. The wife did not claim the children on her return, but several years later contended she is entitled to the exemptions. The Tax Court held the husband was not entitled to claim the child as dependency exemptions because he failed to satisfy the requirement that the noncustodial parent attach a declaration signed by the custodial parent confirming that she would not claim the children. The Tax Court held the custodial parent was entitled to the exemptions. Miller v. Commissioner, 114 T.C. 13 (2000).

(6) Practice Note:

(a) The custodial parent should insist on any releases to the exemption being conditional on child support payment being current.

(b) The noncustodial parent should insist on unconditional releases to avoid litigation in the event the custodial parent refuses to sign a release without cause.

(c) The Form 8332 does not contain a cancellation date. The custodial parent need only sign the form once, but the noncustodial parent must attach it to his or her return every year.

b. A multiple support agreement (IRC § 152(c); IRS Form 2120, Multiple Support Declaration).

(1) If two or more people together pay over half of the support of a child or other individual, but no one person alone pays more than half, one of the payors may be treated as having provided over half the support and may claim the supportee as s dependent if:

(a) The taxpayer paid over 10% of the total support;

(b) If not for the support test, the taxpayer could claim the dependency exemption with respect to the supportee; and

(c) The claimant attaches to his or her tax return an IRS Form 2120 signed by every other person who meets the previous two requirements.

(2) Form 2120 states that the person who signs it will not claim the dependency exemption for that year.

c. The noncustodial parent is entitled to claim the child pursuant to a pre-1985 decree or agreement and provides over $600 support for the child.

F. Significance of Claiming Dependency Exemption.

1. Either parent may claim a deduction for medical expenses paid for a child regardless of who claims the child as a dependency exemption (IRC §§ 213(d)(5) and 152(e)(6)).

2. Custodial parent waiving exemption may also claim earned income credit (IRC § 32).

3. Only the custodial parent may claim childcare credit even if the right to claim the child as a dependent is waived (IRC § 21).

   a. The Code section does not allow the custodial parent to release the childcare credit to the noncustodial parent.

   b. Divorced or legally separated parents who seek to claim the childcare credit for an under 13 year-old child must meet the custody test. That is where the child receives more than half of his support during the year from his parents, and is in custody of one or both of the parents for more than half of the calendar year. That parent need not be able to claim the child as a dependent and may even have released the dependency exemption to the other parent. I.R.C. § 21(e)(5).

4. Child tax credit.

   a. Beginning in 1998 there was a child tax credit of $400 and it increased to $500 for 2000 (still $600 in 2001-2004).

b. The parent that is "allowed a deduction" with respect to such child will be entitled to the credit. Must be allowed to claim a dependency exemption for a child in order to take child tax credit (IRC § 24(c)(1)(A))

(1) In order to claim the child tax credit, the parent must claim the child as a dependency exemption. The parent claiming the child tax credit must list the child as a dependency exemption on the tax form and include the qualifying child's name and social security number.

(2) If the custodial parent waives the dependency exemption, the noncustodial parent gets both the exemption and the child tax credit.

5. Hope or Lifetime Learning Scholarship credits (IRC § 25A).

a. Must be allowed to claim a dependency exemption for a child in order to take the Hope or Lifetime Learning Scholarship credits (IRC § 25A(f)(1)(A)(iii)).

b. If a child who is claimed as a dependent by another taxpayer incurs qualified tuition and related expenses, the taxpayer, not the child, is deemed to have paid such expense for purposes of both the Hope and Lifetime Learning Credits.

c. Married taxpayers incurring qualified expenses must file a joint income tax return in order to claim the educational tax credits. No credit under I.R.C. § 25A is allowed for married taxpayers filing separate returns. In order to claim the credit, the taxpayer must include the student's name and social security number on his or her return.

G. Planning Strategy for Dependency Exemption.

1. Which spouse will take the dependency exemption(s) and therefore be allowed the child tax credit and / or educational credits?

2. Analyze the true comparative tax savings of dependency exemptions and the child tax credit **per child** (for 2001):

a. 10% tax bracket: Federal taxes saved from dependency exemption ($2,900) equals $290 plus the child tax credit of $600 equals total tax savings of $890.

b. 15% tax bracket: Federal taxes saved from dependency exemption ($2,900) equals $435 plus the child tax credit of $600 equals total tax savings of $1,035.

c. 27.5% tax bracket: Federal taxes saved from dependency exemption ($2,900) equals $797.50 plus the child tax credit of $600 equals total tax savings of $1,397.50.

d. 30.5% tax bracket: Federal taxes saved from dependency exemption ($2,900) equals $884.50 plus the child tax credit of $600 (however, see phase out) equals total tax savings of $1,484.50.

(1) However, the credit is subject to a Phase-out.

(2) For taxpayers with modified adjusted gross income above certain thresholds, the otherwise allowable child tax credit is phased out. The amount of the credit is reduced (but not below zero) by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified adjusted gross income exceeds the threshold amount.

(3) The threshold amount is:

(a) $110,000 in the case of a joint return;

(b) $75,000 in the case of an individual who isn't married; and

(c) $55,000 in the case of a married individual filing a separate return.

3. In a year when the credit is $600:

   a. A couple with one qualifying child who file jointly are entitled to a credit of $550 if their modified adjusted gross income is more than $110,000 but not more than $111,000. They lose the credit completely if their modified AGI is more than $121,000.

   b. A single taxpayer with one qualifying child isn't entitled to any credit if modified AGI is more than $86,000.

4. Many custody arrangements today are for shared or joint custody of the child where each parent has physical custody for 50% of the time. This situation should be addressed in the divorce instrument by stating who is or how the custodial parent will be determined on a year-to-year basis.

5. If the support test in the case of a child of divorced parents applies (I.R.C. § 152(e)), parents can decide between themselves who will take the dependency exemption with respect to their child. While neither the Code nor the Regulations expressly say so, presumably the transfer of the deduction can be made on an ad hoc basis each and every year. Where the custodial and noncustodial parents are in different income tax brackets, the deduction is more valuable tot he higher bracket parent.

6. On a joint return, the married couple can claim exemptions for all persons who are dependents of either or both spouses. On a separate return, a spouse can claim exemptions only for his or her own dependents.

7. If a husband and wife in a community property state file separate returns they can divide the total of their exemptions for dependents between them, but they cannot divide between them any exemption for any one dependent.

H. On a joint return, the married couple can claim exemptions for all persons who are dependents of either or both spouses. On a separate return, a spouse can claim exemptions only for his or her own dependents.

I. If a husband and wife in a community property state file separate returns they can divide the total of their exemptions for dependents between them, but they can not divide between them any exemption for any one dependent.

J. IRS Individual Income Tax Return Exemptions.

1. Check the appropriate block for "Yourself" and "Spouse" if applicable (line 6a and 6b).

2. On line 6c, the taxpayer must specifically list each dependent.

3. Form preparation points to remember:

a. On line 6c the taxpayer must specifically list each dependent to include:

(1) The first and last name.

(2) Each dependents social security number (I.R.C. § 151(e)).

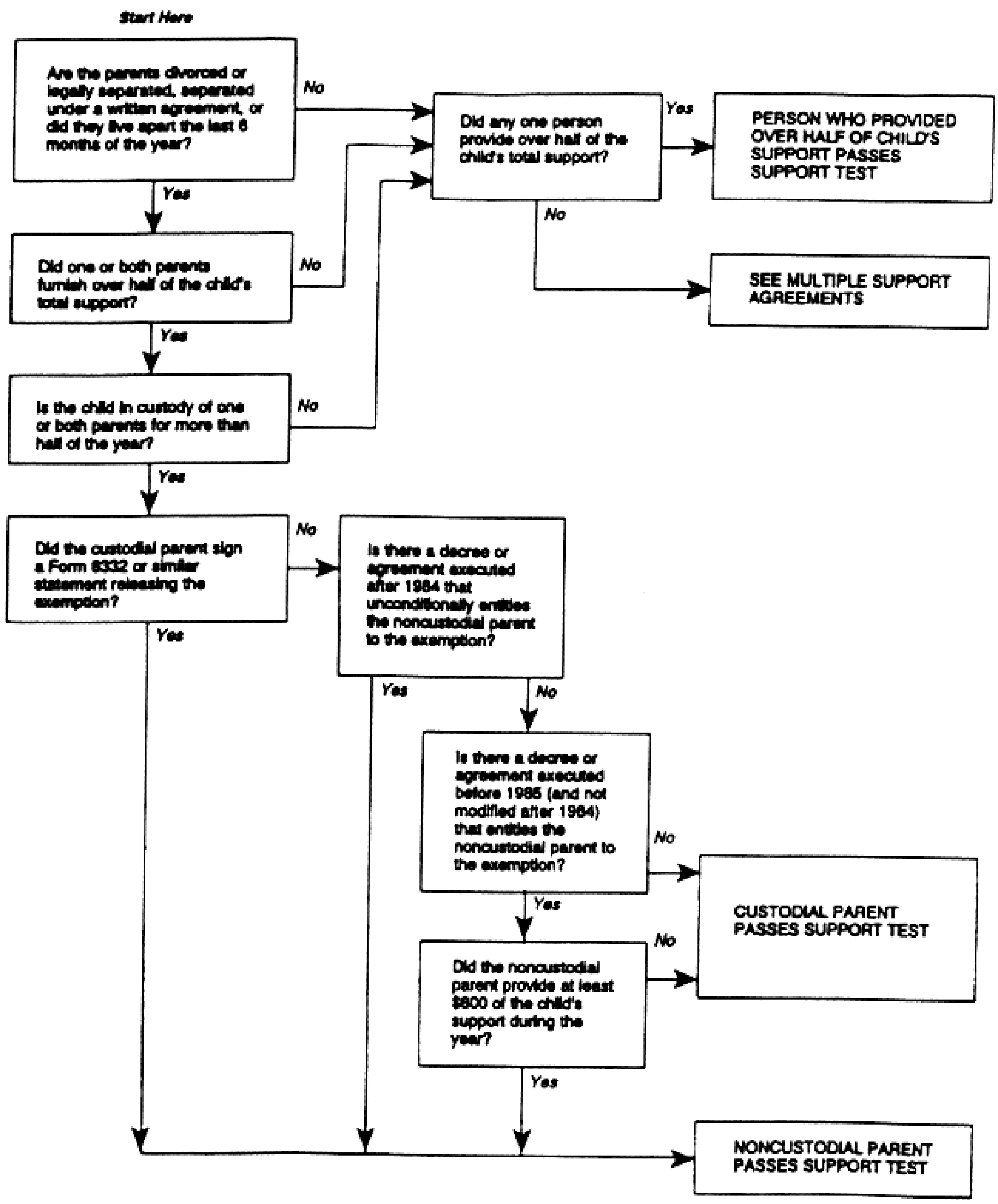
(3) The dependent's relationship to the taxpayer.

(4) A check to indicate if the taxpayer is the child to qualify for the child tax credit.

b. On line 6d add the total number of dependents being claimed (including spouse and self).

4. Multiply the total number of dependents claimed on line 6d times \$2,800 and place the total amount on line 38 (back of Form 1040).

SUPPORT TEST FOR CHILDREN OF DIVORCED OR SEPARATED PARENTS



IX. AMENDING WITHHOLDING CERTIFICATE.

A. A taxpayer must amend his Form W-4, reducing the number of allowances, within ten days:

1. When the spouse he has been claiming is divorced or legally separated from him, or claims her own allowance on a separate W-4;

2. When he loses the right to an exemption for a claimed dependent;

3. When he loses the right to the number of withholding allowances he has claimed. I.R.C. § 3402(f)(2)(B); Treas. Reg. § 31.3402(f)(2)-1(b).

B. The employer must give effect to an amended W-4 no later than the beginning of the first payroll period ending on or after the 30^{th} day after the day the amended W-4 is furnished. I.R.C. § 3402(f)(3)(B)(i).

X. PROPERTY TRANSFERS BETWEEN SPOUSES AND FORMER SPOUSES (I.R.C. § 1041; TEMP. TREAS. REG. § 1.1041-1T).

A. General Rule.

1. Transfers of property and payments between divorcing spouses made pursuant to a written settlement agreement in settlement of marital and property rights or for support of issue of the marriage during minority will be deemed made for adequate consideration and therefore not a gift under I.R.C. § 2512(b) if the parties divorce within the three-year period beginning one year before execution of the agreement. I.R.C. § 2516; Treas. Reg. § 25.2516-1; Treas. Reg. § 25.2516-2.

2. Transfers between spouses or between former spouses, if incident to divorce, will be treated as gifts for tax purposes (I.R.C. § 1041).

   a. The transfer is treated as acquiring the property by gift and the transferee's basis in the property received is the adjusted basis that the transferor had in the property. I.R.C. § 1041(b).

   b. This rule applies even where the transaction is a sale between the spouses or where the transferee-spouse pays a sum of money to the transferor-spouse (as required under the divorce settlement) for the transfer of title to the property to the transferee spouse. Treas. Reg. § 1.1041-1T(a), Q&A-2.

   c. The carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than the fair market value at the time of transfer and applies for purposes of determining loss as well as gain, upon later sale by the transferee. Treas. Reg. § 1.1041-1T(d), Q&A-11. However, there are exceptions that apply to certain transfers in trust (where liabilities assumed by the trust exceed the transferor's adjusted basis) and to transfers of installment obligations into a trust. I.R.C. § 1041(e) and § 453B(g).

   d. The transferor must, at the time of the transfer, give the transferee records sufficient to determine the adjusted basis and holding period of the property at the date of the transfer. Treas. Reg. § 1.1041-1T(e), Q&A-14.

3. Result--no tax on transfer because <u>no</u> recognition of gain or loss; transferor's basis carries over to transferee. Under the tax-free exchange rules, recipient spouse may incur tax liability on a later sale because his/her basis in the property is the same as the transferor-spouse's basis.

Example: In a property settlement accompanying a divorce, H plans to give W $15,000 worth of stock that H bought for $5,000. If W later sells the stock for more than $5,000, W bears the tax burden for the profit above H's basis. W should bear this in mind in arriving at the settlement.

4. Rule applies not only to transfers for release of marital rights, but also for transfers in exchange for property, liabilities, or other considerations.

Example: Godlewski v. Commissioner, 90 T.C. 200 (1988). H and W purchased home jointly for $32,200 in 1973. Property settlement agreement provided that W would convey her interest in home to husband for $18,000. After paying W, H sold home to third party for $64,000 in 1984. IRS used original basis ($32,200) to figure gain. H contended that he was entitled to increase his basis to $50,200 (original $32,200 + $18,000 he paid to buy W out). Tax Court disagreed--I.R.C. § 1041(b)(2) and Temp. Treas. Reg. § 1.1041-1T(d)A-11 preclude transferee spouse from increasing basis even in a bona fide sale when I.R.C. § 1041 applies. H owed tax on entire gain ($64,000 - $32,200).

5. Parties should transfer appropriate records to establish the basis of property involved in marital property transfers (see Appendix F for sample clauses mandating cooperation between the parties on marital property transfers).

B. Qualifying Transfers.

1. All transfers between current spouses.

2. Transfers between former spouses related to the cessation of the marriage.

   a. Made pursuant to decree or divorce instrument and within six years of divorce (Temp. Treas. Reg. § 1.1041-1T(b) Q and A7; Priv. Ltr. Rul. 9306015 (Nov 13, 1992) (Transfer by taxpayer's former husband more than six years after end of marriage was not transfer incident to divorce under I.R.C. § 1041)), or

   b. Made within one year from date of divorce. I.R.C. § 1041(c)(1).

3. Exception: transfers to a nonresident alien spouse are taxed (I.R.C. § 1041(d)).

C. Military Retired Pay:

1. Military retired pay received remains includable in income even after state court classifies it as property of both retiree and his former spouse. The Uniformed Services Former Spouses' Protection Act permits courts of competent jurisdiction to treat "disposable retired pay" payable to a member or former member as property of the member and his spouse (or former spouse) in accordance with the law of the jurisdiction of the court. However, for purposes of federal income taxation laws the state court order does not change the legal status of the retired pay from income subject to the income taxation to property subject only to the law of property. Priv. Ltr. Rul. 98-42-034 (Oct. 16, 1998).

2. Wife had taxable income on the amounts she received from her ex-husband's military retirement pay even though she received the payments under a property settlement. The payments were taxable because pensions are includable in gross income (I.R.C. § 61) and because the spouse had a property interest in her ex-husband's military retirement pension. Mess. v. Commissioner, T.C. Memo. 2000-37 (2000).

3. Under a property settlement agreement, wife was to receive fifty percent of her husband's monthly military retirement pay as a "property settlement." After the wife began to receive the payments, the husband deducted the amounts as alimony payments, and the wife did not report the monthly payments on her tax return. The Tax Court held that the payments the wife received were in fact alimony and includable in gross income. Labeling the payments as a "property settlement," without more, is not an explicit direction that the payments are not includable as gross income. The Tax Court noted that the provisions of the divorce decree and property settlement agreement did not specifically address the tax consequences of the payments, and a commonsense reading of the documents did not establish a nonalimony designation. Baker v. Commissioner, T.C. Memo. 2000-164.

4. See Appendix J for division of military retirement pay tax information.

D. Practical Considerations.

1. All other things being equal, the party in the lower tax bracket should be assigned assets with the greatest amount of unrealized gain. The value of appreciated property should be discounted by the amount of future tax liability.

2. Assets on which a loss will be recognized on sale should be assigned to the spouse in the higher income tax bracket.

3. If marital asset is family home, consider the impact of the transfer on eligibility to exclude the gain under I.R.C. § 121.

XI. LEGAL FEES IN OBTAINING A DIVORCE.

A. General Rule. A taxpayer generally cannot deduct attorney fees incurred in connection with a divorce action. I.R.C. § 262, Treas. Reg. § 1.262-1(b)(7), (see United States v. Patrick, 372 U.S. 53 (1986); Gilmore v. United States, 290 F.2d 942 (Ct. Cl. 1961).

B. Exceptions.

1. The portion of attorney's fees allocable to consultation and advice on tax matters is deductible (I.R.C. § 212(3)).

a. Allocation of fees in billing statement required. Hall v. United States, 78-1 U.S. T.C. (CCH T 9126 (Ct. Cl. 1978); Carpenter v. United States, 338 F.2d 366 (Ct. Cl. 1964) (court permitted deduction of 70% of attorneys fees as allocable to tax matters).

b. Can include fees paid to appraisers, actuaries, and accountants for services in determining correct tax or in helping to get alimony.

c. Fees paid to a *spouse's* attorney for tax advice are not deductible. United States v. Davis, 370 U.S. 65 (1962).

d. Taxpayer paying attorney fees for soon-to-be-ex-spouse may increase "alimony" to include ex's attorney fees and obtain increased "alimony" tax benefit.

2. A taxpayer may deduct attorney fees connected with the quest for obtaining taxable income such as alimony (see I.R.C. § 212(1); Treas. Reg. § 1.262-1(b)(7); Wild v. Commissioner, 42 T.C. 706 (1964), acq.1967-2 C.B. 4).

a. Legal fees to collect past due amounts.

b. Seeking increases in alimony.

c. Working out an agreement for alimony.

3. A taxpayer who has been successful in reducing alimony payments may not deduct his attorney fees (Hunter v. United States, 219 F.2d 69 (2d Cir. 1955)).

C. Miscellaneous Deduction Rule. Allowable attorney fees are an itemized deduction subject to the 2% limit on miscellaneous deductions.

XII. ESTATE PLANNING

A. Prior to or immediately after divorce.

B. Revise existing documents.

1. Wills.

2. Trusts.

3. Power of Attorney.

4. Living Wills/Advance Medical Directives.

C. Review inventory of assets and ownership. These items must be looked at by both the estate planning attorney and the family law attorney to make sure ownership is properly changed during the marital dissolution action.

D. Review all assets owned with beneficiary designations.

E. What are the new estate planning goals of the client?

1. Explain to clients that have no existing formal estate planning documents what will happen with their assets upon their death during the pendency of the divorce if nothing further is done.

2. Testate versus intestate pending divorce. What is the state law regarding disinheriting a spouse versus a surviving spouses right to elect to take a percentage of probate estate of the first spouse to die?

3. Guardianships and Trusts for Children.

a. Same guardian for children as control over assets or different trustees and successor trustees?

b. To protect against need for court-directed guardianships (cost and time).

XIII. CONCLUSION.

APPENDIX A

DIVORCE TAX CHECKLIST FOR THE DOMESTIC RELATIONS PRACTITIONER

A. General Tax Considerations.

1. What are the current taxable and nontaxable incomes of each of the parties? What are their projected incomes for the future? Their expenses?

2. Does either party presently plan to remarry in the near future?

3. Where will the parties' children live?

4. What is (a) the present fair market value, (b) the adjusted tax basis, and (c) the present holding period for each marital asset of the parties? Each material nonmarital asset?

5. What are the debts of the parties? Do they specifically encumber any assets?

6. Are there any business assets on which an investment tax credit has been claimed which may become personal assets of either spouse as a result of the divorce?

7. Does either spouse own stock in a closely held corporation?

8. Should parties file jointly this year? Any future years?

9. Allocation of dependency exemptions for children?

   a. Does party in higher tax bracket have right to claim exemption?
   b. Has custodial parent made waiver of right to claim child contingent upon timely receipt of support?

B. Support/Alimony Payments.

1. Does instrument expressly recite that payments cease on payee's death?

2. Are payments reduced or terminated on the happening of any contingency concerning an event in the lives of the parties' children or at a time which can clearly be associated with such an event?

3. Do any payments exceed $15,000 per year in any of the first three years if the agreement is signed after January 1, 1987?

4. Have parties considered making support payments nondeductible and nonincludible?

5. Has payor been advised to make support payments pursuant to a qualifying instrument?

C. Property Division Checklist. Basic rule: transfers between spouses/former spouses no longer taxable events.

1. Have all divisible assets been identified, valued, and assigned a proper adjusted basis?

2. Is any property to be sold?

   a. Will gain/loss be realized?
   b. Asset assigned to party able to maximize tax benefit of gain or loss?

3. Have the parties considered sales of assets to third parties to recognize gain or loss?

4. Is the transferee spouse a nonresident alien?

5. Have the parties considered encumbering any assets and dividing the cash?

6. Has investment tax credit been claimed on any assets which will become personal use assets after transfer?

7. Have the parties been advised of the advantages of Sections 121 and 1034 in deciding what to do with their principal residence?

8. Have high basis, low value assets been assigned to the party in the higher tax bracket? Have low basis, high value assets been assigned to the party in the lower tax bracket?

9. Has all information on basis and holding period of transferred property been exchanged?

APPENDIX B

SAMPLE CLAUSES FOR FILING RETURNS

1. Clauses for filing a joint return.

   a. Husband and Wife agree that if no final decree of divorce has been entered on or before December 31, 20___ they will file joint federal and state income tax returns for that year. They shall divide equally any refunds received or shall equally pay any taxes due.

   b. Each party shall be responsible for that fraction of the total tax imposed on their combined income for that year which is the same as a fraction, the numerator of which is his or her gross taxable income for the year and the denominator of which is the parties' combined gross taxable income for the year. Each party warrants and represents to the other that the information he or she will provide in connection with the filing of this joint return will be accurate and complete, and each hereby agrees to indemnify and hold the other party completely harmless from the consequences of any breach of this representation and warranty.

   c. The undersigned do hereby agree to indemnify each other, and hold each other harmless, for any interest, penalty, or deficiency resulting from, or imposed against, the joint federal and state income tax returns to be filed by us for the year XXXX. We further acknowledge that each of us is signing said income tax returns without necessarily having any knowledge as to the truth or falsity of any statements contained therein, except as may be furnished by each of us with reference to his or her own income expenses. We also agree to indemnify each other, and hold each other harmless, for any accounting or counsel fees or costs arising out of, or attributable to, any such interest, penalty or deficiency. The execution of this agreement shall be without prejudice to the right of either party to assert any position or claim with respect to the pending matrimonial action between the parties.

2. Future years' returns.

   The parties agree to report all payments and transactions required by this agreement on their separate tax returns in accordance with the tax intent expressed in this agreement; to provide each other with such information (including, without limitation, information concerning the residence of the children and the basis and holding period for any asset) reasonably required by the other party in connection with the preparation of his or her federal and state income tax returns; and to execute and deliver to the other party such documents as may be required to implement the tax intent expressed in this agreement.

3. Clause for outlining rights on past years' returns.

The parties have previously filed joint federal and state income tax returns, paid all taxes due thereon, and divided all funds received for the years 20___ through 20___. In the event any further refund is received or any tax, interest, or penalty is determined to be due with respect to any such return after the date of this agreement, the parties shall equally divide any such refund or shall equally pay any such tax interest or penalty as the case may be.

APPENDIX C

SAMPLE CLAUSES RELATING TO SUPPORT PAYMENTS

1. Clause acknowledging taxability of maintenance payments.

   The parties acknowledge that under present law payments by the Husband to the Wife are intended and will constitute taxable income to the Wife and a tax deduction to the Husband, and the sums provided for herein for maintenance payments have been computed with those tax consequences in mind and in consideration of the relative tax burdens and benefits to each of the parties.

2. Clause making payments nondeductible and nonincludible.

   Husband shall pay to Wife the sum of __________ per month until the death of either party or Wife's remarriage or cohabitation, whichever shall occur first. The parties agree that these payments shall not be deductible by Husband or includable in Wife's income pursuant to Section 71(b)(1)(B) of the Internal Revenue Code.

3. Clause listing social security numbers and requiring parties to cooperate.

   The Wife represents that her Social Security number is 000-00-0000; the Husband represents that his Social Security number is 111-11-1111. Each party shall provide to the other on a timely basis such income tax forms and information as may be necessary or desirable to comply promptly with the laws and regulations of any taxing authority.

4. Clauses protecting alimony payor against possible change in tax laws.

   If maintenance payments should be or become no longer fully tax deductible to the Husband (or not used to reduce his gross income by the full amount of said payments), appropriate adjustments shall be made so that the after-tax burden of payments by the Husband shall be equivalent to his burden as though said payments were tax deductible by him.

   If maintenance payments should be or become no longer fully tax deductible by the Husband or should no longer be fully tax reportable as income by the Wife, then there shall be an adjustment of the maintenance payments so that the relative tax burdens and benefits to the parties will be in the same proportion as they existed as of the time of the execution of this agreement.

APPENDIX D

EXAMPLE OF RECAPTURE RULES

This example illustrates the post-1986 recapture rules:

Colonel and Mrs. Ali Mony have decided to separate after years of marital discord. They've agreed to sell their family home for $160,000 and share the proceeds equally. Colonel Mony proposes to transfer his wife's share in three payments over three of the years following the separation so he can take an alimony deduction for the payments in these years. Since Mrs. Mony will be completing her college education in the next two years and will not be working, she agrees to the proposal and it is written into their separation agreement.

Colonel Mony makes alimony payments of $50,000 in the first post-separation year, $25,000 in the second year, and $5,000 in the third year. The payments made by COL Mony in years one and two are fully deductible by him and includable in Mrs. Mony's gross income. Colonel Mony must, however, recapture $5,000 in year three for the second year's excess payment. This amount is the sum by which payments in the second year ($25,000) exceed payment in the third year ($5,000) by more than $15,000.

Colonel Mony must also recapture $22,500 in year three for the excess payment made in year one. This is the amount by which payment in the first year exceeds the average of payments in years two and three by more than $15,000. When making this determination, note that only $20,000 is treated as being paid in year two because the average of payments made in the second and third year does not include the $5,000 that was recaptured.

<u>Recapture for year two</u>:

amount paid in year 2........$25,000
amount paid in year 3....... <u>$ 5,000</u>
difference................ . $20,000
less differential allowed. .. <u>$15,000</u>
amount recaptured......... ... $ 5,000

<u>Recapture for year one</u>:

amount paid in year 1..... ...$50,000
average paid in years 2 & 3
($20,000 + $5,000 x .5)......<u>$12,500</u>
difference.......................... $37,500
less differential allowed.... <u>$15,000</u>
amount recaptured............ $22,500

<u>Total recaptured in year three</u>... $27,500

APPENDIX E

SAMPLE CLAUSES RELATING TO DEPENDENCY EXEMPTION

1. Clause for release of dependency exemption to noncustodial spouse.

    For the year 20_____ and any calendar year thereafter, the Husband provides any support to the Wife and/or for the children under paragraph _____, above, the Wife shall not claim the dependency exemption for any of the minor children of the parties for federal or state income tax purposes, the parties expressly agreeing that the Husband shall claim all such exemptions on his own returns. The parties further agree that each shall execute such documents, including any such form as may be provided by the Internal Revenue as the release of dependency exemptions, as are necessary and/or appropriate to effectuate the foregoing provision.

2. Clause for allocation of dependency exemption to a noncustodial spouse on a year-by-year basis.

    As to any calendar year in which the Husband has made timely payment of all child care amounts for the benefit of JOHN (the minor child of the parties), that are required under paragraph _____ of this Agreement and that are due and payable as of December 31st of such year, the Husband shall be entitled to claim JOHN as his dependent for purposes of his federal and state income tax returns for such year; and, as to each and every such year as to which the Husband meets the foregoing requirement, the Wife shall execute an appropriate declaration releasing her right to claim JOHN as a dependent, such declaration to be executed and delivered to the Husband no later than January 31st of each year with respect to the preceding year.

3. Exemptions to be shared or alternated.

    Husband shall be entitled to claim the parties' youngest child and Wife the parties' eldest child.

    Husband shall be entitled to claim all three of the parties' children in odd-numbered years and Wife to claim them in even-numbered years.

APPENDIX F

SAMPLE CLAUSES RELATING TO PROPERTY TRANSFERS

1. Clause reciting that transfer of property is tax-free transaction.

    The parties believe and agree that the transfers of property between them required by paragraphs _____, ____, and ____, above, are tax-free transfers of property between them made pursuant to Section 1041 of the Internal Revenue Code and are not taxable sales or exchanges of property or payments for alimony or child support. Each party covenants and agrees not to take any position inconsistent with this belief and agreement, including, without limitation, any position with respect to the basis of any asset on his or her tax returns filed after the date of this agreement.

2. Clause containing transferor's warranties as to basis and holding period.

    Husband warrants and represents to Wife that he has held the _________stock to be transferred to her pursuant to paragraph_________, above, since ______________ and that his adjusted basis therein at the time of transfer to Wife will be ________. Husband hereby agrees to provide Wife with such documents and information as she may require from time to time to establish these matters.

APPENDIX G

TAX & PARTICULAR ASSET TRANSFERS

Annuities: Under § 72, an annuitant excludes from gross income a pro rata portion of the annuity's cost from each annuity payment received. The transferor spouse may transfer his interest in an annuity to his transferee spouse and the latter continues to exclude from each payment a pro rata portion of the cost.

Life insurance: Transfer of a life insurance policy from the insured transferor spouse to the transferee spouse would normally not produce any income (§ 1041(b)(1)), estate (§ 2042), or gift (§ 2516) tax. [Note: Except for a qualifying transfer made pursuant to divorce, the proceeds and the gift tax paid on the transfer would be included in the decedent's gross estate if the transferor should die within three years of the transfer (I.R.C. § 2035(c), (d)(1)). I.R.C. § 2043(b)(2); however, places any qualifying transfer between divorcing spouses outside the gross estate, even if made within three years of death.] By reason of the transfer, the proceeds of the policy would be exempt from income tax if paid by reason of the death of the insured (§ 101(a)(1)). The premiums may be paid as alimony under a provision like this one:

> H shall transfer to W ownership of the ____________ Life Insurance Company $____ life insurance policy on his life and shall pay all future premiums due on this policy until W's death or his death, whichever shall first occur, as alimony.

IRAs: Under § 408(d)(6), they may be divided tax-free between divorcing spouses upon the entry of an appropriate court order or execution of an appropriate agreement. The portion of the IRA paid to the nonowner spouse may be placed in a new IRA for his/her benefit. [NOTE: a non wage earning spouse receiving alimony remains eligible for a deductible IRA, providing that he/she is not covered under an employer's plan.]

Marital home: No tax on transfers pursuant to § 1041. If the spouses sell the home, there will be no tax on the gain provided that they have lived in the home for two years and the gain does not exceed $250,000 ($500,000 if they file a joint return). In addition, so long as the spouse who leaves the home does so pursuant to a divorce or separation instrument, he will be treated as having lived in the home for purposes of excluding the gain under I.R.C. § 121. There are some advantages to the spouse who retains the marital home:

a. Mortgage interest deduction (if itemize);
b. Real estate tax deduction (if itemize);
c. Eventual exclusion of the gain, if the two-year test is not met at the time of divorce.

Transfers of savings bonds. Rev. Rul. 87-112, 1987-2 CB 207, holds that the owner of Series E or EE savings bonds electing to defer annual reporting of income thereon must include in reportable income all accrued value of the bonds in the year of transfer to a spouse under a marital settlement agreement. Section 1041(a) is held not to shield "income," as opposed to "gain," from recognition. Effect - this ruling seeks to and treats the accrued and untaxed interest increment on bonds as an "assignment of income" problem and, in keeping with such characterization, as assignment of income to another, is recognized immediately as taxable income to the owner of the income so assigned. Of course, the spouse receiving the bonds receives a step-up in basis equal to the FMV of the bonds, including the income subject to tax in the transferor's hands.

APPENDIX H

DIVIDING MORTGAGED PROPERTY

Under existing tax law, no gain is realized when a taxpayer borrows money and secures a loan with a mortgage on the property. The obligation to repay offsets the loan so that neither the taxpayer's basis in the property nor his/her net worth is affected. But on a later sale, gain (or loss) is calculated by subtracting the property's adjusted basis, without reference to the loan, from the amount realized on the sale of the property which includes the amount of the mortgage indebtedness.

> Example: H and W jointly own property, with a zero basis, subject to a $30,000 mortgage, and FMV of $150,000. Pursuant to divorce instrument, H transfers his interest to W, subject to the mortgage. Under the current law, H recognizes no gain and W's basis is $30,000 ($15,000 plus a carryover of $15,000).

Section 1041 makes planning in this area considerably simpler, inviting an encumber and divide strategy. In the above example, the property could have been mortgaged for an additional sum of $120,000, so that its "net value," i.e., value net of encumbrances, is zero. The spouses have taken advantage of the appreciation in the value of the property to "squeeze out" potential gain in the form of loan proceeds, which they own jointly. H could then transfer his interest in the property to W, with W assuming the mortgage. H is bailed out of the property and left with $60,000 cash in hand at no tax cost (§ 1041(b)(2)). When W later sells the property, gain will be recognized: if W sells for $10,000 cash subject to the mortgage liability of $150,000, she realizes $160,000. Since her basis is the pre-divorce basis of $30,000, there is a $130,000 gain on the sale.

APPENDIX I

KEY DIVORCE TAX PRACTICE TIPS

1. If representing a custodial parent, agree to make annual waiver of right to claim an exemption on behalf of a child contingent upon receipt of timely, adequate support.

2. Advise clients making voluntary support payments (i.e., pursuant to AR 608-99) to execute a qualifying instrument.

3. Continue to specify in separation agreements that alimony payments cease on death of payee spouse.

4. Any support payments to be reduced upon a change in a child's status will be treated as nondeductible child support.

5. Ensure that clients receiving appreciated marital property discount the value of that property for future tax liability.

6. Advise divorcing taxpayer who had been claiming marital status for withholding to file a new Form W-4 within 10 days after divorce.

7. Counsel spouse regarding the Innocent Spouse rules and consider the liability election pursuant to I.R.C. § 6015.

APPENDIX J

DIVIDED RETIREMENT PAY TAX INFORMATION

The Defense Finance and Accounting Service (DFAS) reports retirement income to military retirees using IRS Form 1099-R. For marriages ending on or after 3 February 1991, the military retiree is not taxed on that portion of retired pay the finance center pays direct to a former spouse. (*See* Public Law 101-510, section 555, enacted on 5 November 1990.) Disposable retired pay is now calculated before taxes are withheld. Under this law, DFAS will withhold taxes from and report payments to the IRS separately for each payee (retiree and former spouse) when making direct payment to a former spouse.

The retiree's Form 1099-R will reflect net retired pay (gross retired pay minus gross payment to the former spouse). DFAS will also issue the former spouse a Form 1099-R to show taxes withheld from any retired pay DFAS paid to the former spouse as property divided under a court order.

In cases where the retiree, and not DFAS, makes the payment to the former spouse, DFAS withholds and reports only with respect to the retiree, whose 1099-R will reflect the entire amount of the retirement pay. In these cases and those cases under the pre-3 February 1991 rules, retirees should subtract from income the amount paid to the former spouse during the year from the amount stated on the 1099-R and attach an explanatory letter to the tax return. The letter should state that the amount subtracted was paid to a former spouse under the Uniformed Service Former Spouses' Protection Act (USFSPA) pursuant to a divorce decree and MUST identify the former spouse by name and Social Security number.

Before the amendment to the USFSPA (effective 3 February 1991), disposable retired pay (which is what can be divided) was calculated after income taxes were withheld, i.e., if a former spouse was entitled to 50% of the disposable retired pay, the 50% was figured on the amount left over after taxes were withheld. DFAS did not withhold taxes from, or report to the IRS, any amount paid directly to the former spouse. Although each party was responsible to pay taxes on the portion of the retired pay received, the parties had to make the adjustment on their respective tax returns.

Example: Suppose H receives $200 in retirement pay before taxes, W is awarded 50%, and the applicable tax rate is 20%. Under the pre-Feb 91 law, taxes ($40) are subtracted first from the total retirement pay to determine what is divided ($160). Thus, W's share is $80. If DFAS did not separately report and withhold for W, it would pay W $80 and H $80, but it would report $200 to the IRS as taxable income for H (no report for W). Thus, H is credited with the $40 tax withheld. This might result in W paying the tax on the $80 she received without any adjustment from H at the end of the year. Post-Feb 91, the tax calculation occurs after determining disposable retired pay (here $200, $40 tax); and DFAS reports $100 taxable income to each; and IRS "credits" each with $20 tax withheld.

Amounts of retired pay that go to a former spouse as alimony, child support, or a voluntary allotment continue to be reported as income to the retiree and appear on the retiree's Form 1099-R. They are not reported on a Form 1099-R to the former spouse.